House of Commons

Work and Pensions Committee

PENSION CREDIT: GOVERNMENT RESPONSE TO THE SECOND REPORT OF SESSION 2001-2002

Second Special Report of Session 2001–2002

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The Work and Pensions Committee is appointed by the House of Commons to examine the expenditure, administration and policy of the Department for Work and Pensions and its associated public bodies.

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SECOND SPECIAL REPORT

The Work and Pensions Committee has agreed to the following Special Report:

PENSION CREDIT: GOVERNMENT RESPONSE TO THE SECOND REPORT OF SESSION 2001-2002

1. The Work and Pensions Committee agreed its Second Report of Session 2001-2002 on Pension Credit on 10 April 2002. The Report was published on 12 April 2002 as House of Commons Paper No. 638.

2. We have now received in the form of a letter from the Minister of State for Work and Pensions, the Government's Response to the Report, which is printed as an Appendix to this Special Report.

APPENDIX

Archy Kirkwood MP
Chairman
Work and Pensions Committee
7 Millbank
London SW1P 3JA

11 June 2002

Dear Archy,

Please find enclosed the Government's Response to the Committee's report of 12 April into the Pension Credit.

A copy of this letter goes to the Committee Clerk.

The Rt Hon Ian McCartney MP

REPLY BY THE GOVERNMENT TO THE SECOND REPORT OF THE WORK AND PENSIONS COMMITTEE SESSION 2001-2002 ON PENSION CREDIT

Conclusions, Recommendations and Responses

1. The Government welcomes the Select Committee's Report on Pension Credit and is grateful for the Committee's support for the key principles and main provisions of Pension Credit. In particular, we appreciate the Committee's acknowledgement that Pension Credit will boost pensioners' incomes and ensure that pensioners will be better off as a result of having saved for their retirement, compared to those who have not.

2. The Pension Credit consultation paper, which set out the Government's broad aims, was published in November 2000 (and can be accessed at www.dss.gov.uk/consultations/2000/index.htm). The consultation period ran from 9 November 2000 to 28 February 2001. The views of groups that represent pensioners' interests, including leading pensioner organisations, pension providers and individual pensioners were sought. Over 400 responses were received. Copies of the responses received from organisations have been placed in the House of Commons Library.

3. The State Pension Credit Bill was introduced in the House of Lords on 28 November 2001. The Committee's Report, published on 12 April, has been a valuable resource for debate and consideration during the Bill's progression through the House of Commons.

Impact on pensioner poverty

(a) We welcome the extra spending that the Pension Credit will represent (paragraph 20).

Effect on rewards for saving

(b) We welcome the recognition and extra reward that the Pension Credit will provide for most of those who have saved for their retirement (paragraph 23).

4. Since 1997 the Government's priority has been to address the immediate problem of poverty amongst today's pensioners. From this year we will be spending an extra £6 billion a year in real terms on pensioners as a result of policies introduced since 1997. This includes £2.5 billion more on the poorest third of pensioners. Pension Credit builds on that with a total additional cost of some £2 billion a year in 2004/05. The guarantee element of Pension Credit will ensure that, from October 2003, no single pensioner need live on less than £100 a week or £154 for couples.

5. As the Committee has recognised, the reward for savings, which we are introducing through Pension Credit, will remove the long-standing injustice in the existing system that means millions of pensioners who struggled to put money aside for their retirement find they are little or no better off than people who have saved nothing. Furthermore, Pension Credit signifies an end to the weekly means-test for those aged 65 and over. The Pension Service will be responsible for delivering services to pensioners in a totally new way, dedicated and sensitive to their needs. The way pensioners' incomes are assessed will be fairer and less intrusive, and the claims process will be simpler. In the 1930s means-testing was used to exclude people from assistance. The purpose of Pension Credit is the exact opposite. It is about inclusion, to ensure that people qualify for the assistance to which they are entitled.

(c) We recommend that the Government should inquire into the immediate and long-term costs, benefits and affordability of extending the Pension Credit in this way [rewarding people with deficient NI records] and make public the results (paragraph 32).

6. The issue of rewarding all second pension and savings income, not only that above the basic state pension has been raised during the Bill's debate in both Houses of Parliament. The Government has considered this suggestion in detail.

7. A key objective of Pension Credit is to reward those who have worked hard and saved. It follows that a full state pension, based on contributions (and credits for those with broken work records and for those who had caring responsibilities) should be the foundation of state provision. For this reason, we have deliberately set the start point of the savings credit at an amount that in its first year will be equivalent to the expected rate of the full basic state pension in 2003.

8. To do otherwise would increase the cost of Pension Credit significantly. For example, rewarding all income for those aged 65 and over by removing the savings credit threshold entirely would cost around £8 billion on top of the existing Pension Credit package. It would also extend support much higher up the income distribution, contrary to our declared aim of focussing support on those pensioners who need it most.

Effect on incentives to save

(d) We have concluded that, whilst the Pension Credit will enable today's pensioners to see a reward for saving, there is no clear evidence that it will actually increase younger individuals' savings (paragraph 37).

9. The Government attaches great importance to providing better information to help people make informed decisions about saving for their retirement. The Department for Work and Pensions is working in partnership with employers and pension providers to provide individuals with pension forecasts giving both state and current private pension details. For the first time individuals, including young people, will have a clear statement of their current and projected pension rights.

10. The Department has an ongoing major publicity campaign to ensure that people are aware of the importance of starting to save for retirement, as well as reviewing any pension plans they already have. The campaign is supported by a range of straightforward impartial guides on pension options so people can make a decision that they are comfortable with. As part of this campaign we have been targeting activity on various segments of the population who seem to be less inclined to think about saving for their retirement - one group we have specifically targeted is young people.

11. There is inevitably a tension between the need to ensure there is a floor below which pensioner incomes do not fall, and the need to ensure that today's workers have a clear incentive to save. Pension Credit is the mechanism for both ensuring that we can tackle poverty amongst today's pensioners, while not discouraging future pensioners from saving.

12. Under the current Minimum Income Guarantee (MIG) 2.5 million pensioners face a benefit withdrawal rate or taper of 100% for any additional income above the MIG level. This means their benefit entitlement is reduced by a pound for every pound of additional income received. For example, a pensioner who saved in an occupational pension and receives £20 a week in addition through his Basic State Pension would be no better off under MIG than his neighbour who only had a Basic State Pension.

13. The situation is greatly improved under Pension Credit. It will give pensioners a cash addition of 60p for every £1 of income they have above the level of Basic State Pension up to a maximum of £13.80 a week (£18.60 a week for couples). After this the maximum reward will be reduced by 40p for every £1 of income above the income guarantee so that pensioners with incomes up to £135 a week (£200 a week for couples) will benefit. The pensioner in the example above would receive an additional £12 a week for his occupational pension - which is over £600 a year more than under MIG.

14. We estimate the number of pensioners facing the 100% taper when Pension Credit is introduced will reduce to around 900,000, with 700,000 fewer pensioners facing a taper of 40% or more. And those on the 40% taper, if single, could gain up to £13.80 a week (£18.60 in the case of a couple). The key point to note is that pensioners will always be better off having saved under Pension Credit.

15. In addition, the new capital rules in Pension Credit will promote saving. A number of steps have been taken to avoid a situation where pensioners have to draw down on their capital in order to receive a decent regular income:

- we are abolishing the upper capital limit, and the all or nothing effect that currently exists;

- we have listened to responses to the consultation and opted for a notional return rather than actual (pensioners do not want the hassle of recording actual income or having to go to the Building society to bring interest to account just because it suits the Government);

- we have listened to the Financial Services Authority who advise that a rate of return of 10% enables them to continue to give clear advice to savers about the benefits of second pensions;

- we wanted to take as many pensioners as possible out of the capital rules, so the first £6,000 of savings will be completely ignored, meaning that 85% of people entitled to Pension Credit don't need to tell us about their savings at all; and

- ignoring the first £6,000 of savings helps better off pensioners too so that even someone with savings of £20,000 will face an effective rate of return of under 7.5%.

Treatment of earnings by the Credit

(e) **We urge the Government to reconsider its policy on the Credit's treatment of earnings and, subject to cost and affordability shown consequent to such reconsideration, strongly recommend that the first £40 of all weekly earnings income be disregarded in the calculation of the Pension Credit to encourage more pensioners to remain involved with the labour market (paragraph 42).**

16. The Government is committed to promoting active ageing. That is why, within our proposals to spend an extra £2 billion on the Pension Credit:

- we will abolish the remunerative work rule that excludes pensioners who work 16 hours a week or more from receiving Minimum Income Guarantee (MIG);

- we will reward the earnings of those aged over 65 through the savings credit; and

- we will carry forward the existing income support (MIG) earnings disregards .

17. Extending the earnings disregard in Pension Credit, as suggested, would be costly. A £40 a week disregard of earnings for people aged 60 and over in Pension Credit would

cost in the region of £180 million a year. Evidence from the Family Resource Survey shows that the vast majority of pensioners with earnings do not qualify for Pension Credit because their earnings and other income put them beyond the Pension Credit income ranges (around £135 a week for single pensioners, £200 for pensioner couples).

18. We estimate there are only around 70,000 people over 60 with earnings who could qualify for Pension Credit. These pensioners will benefit from Pension Credit financially. The Government believes that the best way to promote active ageing and reward earnings is through Working Tax Credit, together with the abolition of some of the rules relating to work, such as the 16-hour rule, and bringing forward existing earnings disregards into Pension Credit.

The Credit's interaction with other benefits

(f) **We welcome the Government's proposed changes to the rules governing entitlement to Housing Benefit and Council Tax Benefit, which should ensure that no pensioner loses benefit as a result of the Pension Credit. These changes do not, however, alter the case for a more fundamental re-examination of Housing Benefit (paragraph 44).**

19. The Government recognises the need for radical Housing and Council Tax Benefit reform. Our main objective is to ensure that low-income families and pensioners can afford decent accommodation within a framework that extends choice, encourages responsibility and tackles fraud. Additionally, for people of working age our framework includes improving work incentives and for pensioners we are clear that Housing Benefit reform has an important role to play in the Government's wider agenda for tackling and ultimately ending pensioner poverty. We think the development of these objectives will constitute the fundamental re-examination of Housing Benefit that the Committee calls for.

20. The Government has a three-stage strategy for achieving its objectives. The first priority is to improve the administration of Housing Benefit and this is well underway. The second stage, as set out in the Housing Green Paper, is to restructure rents in the social rented sector and we are in the process of developing the detail on this. We shall soon begin work on our third stage, which will involve restructuring benefit support for people on low incomes. This last stage will encompass measures aimed specifically at pensioners, including those resulting from Pension Credit changes.

(g) **We believe that the Department for Work and Pensions and the Department of Health need to make clear how the proposals for the Pension Credit will interact with care charges: pensioners in residential care do not yet know if the real increase in pensioner income from the Credit will be lost through increased home care charges (paragraph 47).**

21. The Government intends that pensioners in residential care and nursing homes will gain from Pension Credit as other pensioners do. The Department of Health is currently considering the details for achieving this.

Assessment of the Credit

(h) **We welcome the five-year assessment periods for the Pension Credit, which we believe will significantly improve the delivery and accessibility of the new benefit. The Department will have to be careful, however, that pensioners who between assessment dates become eligible for help, or more help, under the Credit do not lose out on valuable assistance (paragraph 49).**

22. The Government wants to ensure that everyone who is eligible for Pension Credit, or becomes eligible because their circumstances have changed (perhaps because their

incomes have decreased), knows what they need to do to take up their entitlement. For those who may not be eligible when Pension Credit is introduced The Pension Service plans to use key life events, such as the receipt or award of certain benefits or reaching a certain age, to identify people who may become eligible and encourage them to claim Pension Credit. In addition, a range of leaflets, and other forms of communication will be developed to help pensioners work out whether they are eligible. The key thing for pensioners to know is that if their income from all sources is less than around £135 a week, or £200 a week for pensioner couples (the expected rates for 2003) they should claim. All applications made before October 2004 will be backdated to October 2003.

23. For those already receiving Pension Credit the Government fully accepts the importance of ensuring that pensioners whose incomes fall after an award has been made are aware of the need to contact The Pension Service to have their entitlement recalculated. Those not receiving Pension Credit will be able to contact The Pension Service if they think they have become eligible because their circumstances have changed at any time.

24. Pensioners will be notified if they have been assessed as eligible for Pension Credit and if an assessed income period has been set for them. They will be provided with a detailed break-down showing how their level of benefit has been calculated and what information has been taken into account. They will be told that, apart from a limited number of significant changes (as required for Retirement Pension), they do not have to report certain changes to their circumstances during the five year assessed income period. But that they can report any changes which might increase their level of entitlement.

(i) **DWP employees within the Pension Service who are dealing with the public regularly, either face-to-face or via the telephone, must receive the appropriate level of training and support if they are to inspire the confidence and trust of clients and carry out the job efficiently (paragraph 51).**

(j) **We recommend that the Department should investigate the cost and practicability of providing a free-phone number for claimants as it moves increasingly to the call centre model (paragraph 52).**

(k) **While call centres may bring many advantages to the Credit's administration, we remain convinced of the need for a significant number of local staff able to deal with pensioners on a face-to-face basis (paragraph 53).**

25. The Pension Service has been established specifically to focus on the needs of pensioners, and to provide the very best in customer service. It is key to ensuring that the Government meets its aim of tackling pensioner poverty, and will be an active force in encouraging people to claim their entitlements. As well as receiving technical training to cover the range of state pension provision available, staff will also have customer service training to enhance their ability to deal with customers in a responsive and sensitive manner. Particular emphasis will be placed on effective communication and interaction with customers over the telephone. And, combined with enhanced telephony systems customers will get their claims and queries dealt with quickly by trained experts who understand state pensions and the needs of their customers. The majority of staff who will be recruited to administer Pension Credit in The Pension Service will already be familiar with resolving queries from pensioners. Training and guidance requirements will be considered in detail after Royal Assent to ensure staff are fully prepared for the introduction of Pension Credit in October 2003.

26. One of the main priorities of The Pension Service is to ensure that all pensioners can access the service easily. The current strategy, combining both local and free call rates, aims to strike the right balance between providing a first rate service at a reasonable cost and ensuring accessibility for the majority of customers. Currently staff offer to ring callers back and this will continue.

27. Although the telephone will be the primary means of contact with The Pension Service, we are also committed to providing a wide range of channels to enable customers to contact us more easily and for us to provide a more responsive and tailored service. These include post, iDTV, the internet via The Pension Service website and on a face to face basis.

28. The Government agrees there is a need to offer pensioners a face-to- face service for those who cannot access The Pension Service in any other way. Evaluation of joint initiatives (such as the Better Government for Older People Programme and take up research) has shown that the most effective way to deliver local services is through providing a combination of different channels that are joined up and integrated with organisations that already provide local services to pensioners.

29. The local service is being introduced on a phased basis from 1 April 2002 and will be in place nationwide by October 2002. In the interim, customers will be able to access services through the existing social security network (home visits, caller services in DWP offices, local information or outreach work supported by the network of District Information Officers and the central claim lines for pensioners). The local service will be made up of two key elements.

- **Direct Local Services** with Pension Service staff providing support directly to the customer. This will include a targeted visiting service, appointment based surgeries in third party locations, and a drop-in surgery service for outreach and take-up activities.

- **Partnership Services** which are services provided with partners such as Local Authorities and voluntary sector organisations. Our aim is to work together to provide a more rounded service and discussions with potential partners are currently taking place both nationally and locally. Examples of closer working may include provision of support information and facilities for surgeries or drop-in advice centres so that our partners can provide a service to Pension Service customers.

(l) Adequate provision must be made at all call centres to cope with pensioners from ethnic minorities, for whom English is not their first language (paragraph 53).

30. The Government attaches great importance to The Pension Service providing a service tailored to the needs of all its customers, including those from ethnic minority backgrounds. As part of our commitment to ensure that we provide the best possible service we have facilities which enable customers to access the Language Line - a telephone interpreting service covering over 150 languages. We also produce leaflets in a wide range of languages. In addition, in recruiting staff to deliver our face-to-face services we will endeavour to ensure there is an ethnic mix that reflects the local community. We will also establish closer links with organisations representing different groups within the community to ensure we meet their needs.

(m) The Department for Work and Pensions must ensure that the Pension Service has the necessary resources and expertise to deal with the challenges that the Pension Credit poses (paragraph 55).

(n) We firmly believe that initial take up could be limited by the fact that many pensioners will find it hard to calculate their entitlement, and will, therefore, be deterred from applying. This places a particular responsibility upon the Government to promote take up (paragraph 58).

31. The Government is determined that pensioners will get what they are entitled to. For planning purposes we have assumed that two out of three pensioners will take up their

entitlement in the first full year of Pension Credit given the evidence we have on pensioner's attitudes and on past experience of introducing new benefits. This means taking on a million claims in the first year, on top of the 1.8 million who will transfer to Pension Credit from the Minimum Income Guarantee. We are currently undertaking research among pensioners who may become entitled to Pension Credit which will help us to identify any potential barriers to claiming. This research will inform the strategy that we put in place to promote take up. Our aim is that The Pension Service will succeed in delivering Pension Credit to all those who need it.

32. The Bill has three key elements that will enable The Pension Service to ensure people get what they are entitled to:

- from age 60 people will no longer have to report any savings they have under £6,000, this means that 85% of pensioners entitled to the Pension Credit will not have to report savings;

- from age 65, most pensioners will not have to report changes in income for fixed periods of five years, effectively abolishing the old weekly means test; and

- we will protect the position of people on housing benefit and council tax benefit, ensuring that these pensioners (half the entitled population) maintain their current entitlement as well as benefiting from Pension Credit.

33. We will also introduce numerous changes in the detail of Pension Credit which will greatly simplify the rules. For example we will not require details of the number of hours worked, charitable and voluntary payments and student loans and grants. The combined effect of these measures will be a significant reduction in intrusiveness and complexity and a radical change from the current income support system.

Take up of the Credit

(o) We were concerned about the Department for Work and Pensions' inability to produce reasonable estimates for such an important figure as the take-up of a key Government benefit. We urge the Government to set out clear, and achievable, targets for levels of take-up of the Pension Credit (paragraph 61).

34. The Department for Work and Pensions already report on the take-up of a range of income-related benefits (Income Support, Housing Benefit, Council Tax Benefit and Jobseeker's Allowance). Research is underway to improve the accuracy of take-up estimates for the Minimum Income Guarantee and this research will also explore attitudes towards Pension Credit among pensioners who become eligible from October 2003 which will help us to understand take-up of Pension Credit in the future. Furthermore, an evaluation plan is being developed for Pension Credit in line with Treasury guidelines to ensure that there are robust mechanisms in place for establishing an accurate base-line prior to the introduction of Pension Credit in 2003 and for monitoring the Government's progress in tackling pensioner poverty, modernising the minimum income guarantee for pensioners and rewarding thrift after 2003. Targets for Pension Credit will be published in due course.

Future uprating of the Credit

(p) The Government has gone a long way toward specifying its intentions for indexing the MIG and the Basic State Pension. We urge them to do the same for the Pension Credit to aid Parliament in its consideration of the Bill and to provide more certainty to those involved in the long-term planning necessary for pension provision (paragraph 73).

35. Rates of benefit are reviewed each year, by the Secretary of State for Work and Pensions, taking into consideration the change in the general level of prices in the September prior to the April in which the new rates are to come into force. Generally, contributory and non-contributory benefits are uprated by the Retail Prices Index and income-related benefits by the Rossi index (RPI less housing costs). However, there is discretion to increase rates other than in line with the rate of inflation, for example, the minimum income guarantee was increased by more than inflation to help combat pensioner poverty. And the Government have committed to increasing the guarantee credit by earnings for the rest of this Parliament.

The role of the Pension Credit in the Government's overall pensions strategy

(q) We share the concerns, expressed by many, about whether the State Second Pension has a viable future once the Pension Credit is introduced. We look forward to the Government clarifying the role of the State Second Pension in its overall pensions strategy (paragraph 86).

(r) We urge the Government to publish estimates of the cost of increasing the accrual rate and/or lower earnings threshold for the State Second Pension along the lines described by the Government Actuary (paragraph 87).

36. The Government is concerned that some people may not be able to build a decent income in retirement. That is why we are reforming both state and funded pensions to give more people the opportunity to build up good second pensions. The State Second Pension has been introduced to give better provision for the 18 million people who have been unable to build up pension rights in the past, in particular those who are unable to work because they are caring for others or disabled.

37. Pension Credit and the State Second Pension are complementary. Since State Second Pension rights will be rewarded in Pension Credit they will work together to greatly boost the retirement income of the most vulnerable future pensioners. This means that people within the Pension Credit income range will be able to benefit from both the State Second Pension and Pension Credit.

38. The Government does not therefore accept the view expressed in paragraph 87 of the Committee's report that the Pension Credit is a temporary measure for today's pensioners and those retiring in the near future who will not have been able to benefit from the State Second Pension or Stakeholder Pensions.

39. The Government Actuary has assessed the costs of enhancing the State Second Pension (S2P) by (1) increasing accrual rate and (2) increasing in the Lower Earnings Threshold (LET) to ensure most people would retire with a state pension above the level of the guarantee credit. Estimates of the increase in S2P expenditure required as a result are attached at Annex A, and are based on evidence from the Government Actuary's Department to the Committee on 5 March, at Annex B.

ANNEX A

Summary of note from the Government Actuary to the Department for Work and Pensions in response to recommendation (r)

In the letter to the Second Clerk of the Select Committee (see Annex B), the Government Actuary's Department set out the State Second Pension (S2P) parameters needed to ensure a single person retiring in 2051, who had earned between the lower earnings limit (LEL) and the lower earnings threshold (LET) for each year of their working life, would have a total state pension at least equal to the Minimum Income Guarantee at the point of retirement and for 5 or 10 years after retirement. The required parameters are:

- Changing the 40% accrual rate on the first band of earnings to either 42.5%, 47.7% or 53.4%
- Changing the LET (£10,800 pa in 2002-03) to either £11,200pa, £12,300pa, or £13,500pa.

Section 1 of this paper estimates the cost of changing the accrual rate and section 2 considers the cost of changing the LET. All costs are based on the projections contained in the report by the Government Actuary on the Financial Effects on the National Insurance Fund of the Child Support, Pensions and Social Security Bill 1999 (Cm 4573). They are therefore consistent with published figures.

In each section two tables are given. The first considers the effects on S2P benefit payments, the second the effects on contracted out rebates. Options to change the accrual rates for S2P, or to increase the LET affect the level of rebates paid to people who are contracted out through APPs (appropriate personal pension schemes) or Stakeholder Pensions (but not through occupational schemes).

For consistency with the Report on the Bill, costs are given under two different assumptions about the additional level of contracting out following the introduction of Stakeholder Pensions. These are labelled "Assumption 2" and "Assumption 3".

Broadly, assumption 3 assumes S2P moves to being a flat-rate scheme in 2006-07, with a large consequential increase in the level of contracting out at that point, whereas assumption 2 assumes S2P does not move to being a flat-rate scheme. More details on these assumptions can be found in paragraph 3.5 of the Report on the Bill.

(1) Changing the accrual rate on the first band of earnings

Table 1 shows the effect on projected S2P expenditure of increasing the accrual rate for the first band of earnings above 40%.

If the accrual rate for the first band of earnings were to be increased, then it may be the case that:

- The earnings limit for the top of the second band of earnings would also be increased to the new level such that people earning above the top of the second band of earnings would accrue the same S2P as they would have accrued SERPS (State Earnings Related Pension).
- The accrual rate on the second band of earnings would be decreased.
- There would be no changes to the accrual rates for the other bands of earnings, or to the earnings limit for the top of the second band.

For the purposes of these costings, it has been assumed that there would be no changes to the accrual rates for the other bands of earnings, or to the earnings limit for the top of the second band (that the accrual rates for the second and third bands of earnings would remain at 10% and 20% respectively, and that there would be no change to the top of the second band of earnings).

On contracting out, it has been assumed that rebates to APPs and Stakeholder Pensions would reflect the increased accrual rate on the first band of earnings. For people contracted out through COSRS (contracted-out salary related schemes) and COMPS (contracted out money purchase schemes), it has been assumed that rebate rates would continue to be based on SERPS accrual rates, as now, with benefit expenditure top-ups meeting any difference. Therefore, under these options, anyone who is contracted out through an occupational scheme and who earns above the top of band 2 would get an S2P State top-up after retirement, which is not currently the case.

Table 1 – Effect on S2P benefit expenditure of increasing the accrual rate on the first band of earnings - *£ billion, 1999-00 price terms*

	SP Assumption	2010	2020	2030	2040	2050	2060
Increase in expenditure from S2P accrual of 42.5% on first band of earnings							
	Assumption 2	0.1	0.2	0.7	1.2	1.9	2.8
	Assumption 3	0.1	0.2	0.7	1.2	1.8	2.5
Increase in expenditure from S2P accrual of 47.7% on first band of earnings							
	Assumption 2	0.2	0.7	2.0	3.8	6.0	8.7
	Assumption 3	0.2	0.7	2.0	3.6	5.5	7.6
Increase in expenditure from S2P accrual of 53.4% on first band of earnings							
	Assumption 2	0.3	1.3	3.5	6.6	10.4	15.1
	Assumption 3	0.3	1.3	3.5	6.3	9.5	13.3

Table 2 shows the corresponding effects on the costs of contracted out rebates.

Table 2 – Effect on contracted out rebates of increasing the accrual rate on the first band of earnings - *£ billion, 1999-00 price terms*

	SP Assumption	2010	2020	2030	2040	2050	2060
Increase in rebate costs from S2P accrual of 42.5% on first band of earnings							
	Assumption 2	0.3	0.3	0.4	0.4	0.5	0.5
	Assumption 3	0.3	0.5	0.6	0.7	0.8	0.9
Increase in rebate costs from S2P accrual of 47.7% on first band of earnings							
	Assumption 2	0.8	1.1	1.1	1.2	1.4	1.7
	Assumption 3	1.1	1.5	1.7	2.0	2.4	2.8
Increase in rebate costs from S2P accrual of 53.4% on first band of earnings							
	Assumption 2	1.4	1.9	1.9	2.1	2.5	2.9
	Assumption 3	1.8	2.5	3.0	3.5	4.2	4.8

(2) Changing the LET

Table 3 shows the effect on projected S2P expenditure of increasing the LET above £10,800 pa (in 2002-03).

If such a change were to be made there are a number of options regarding possible consequential changes to the rest of the S2P structure. In this case it has been assumed that if the LET were to be increased, the top of the second band of earnings would also be increased, using the formula (3 x LET - 2 x LEL), unless the resulting limit is above the UEL (Upper Earnings Limit) in which case it is capped at the UEL.

As before, it has been assumed that contracted out rebates for people contracting out through APPs and Stakeholder Pensions would be increased as a result of increasing the LET. For people contracted out through occupational schemes, there would be no change to the amount of rebates paid, with any difference being paid through S2P top-ups after retirement.

Table 3 - Effect on S2P benefit expenditure of increasing the LET - *£ billion, 1999-00 price terms*

	SP Assumption	2010	2020	2030	2040	2050	2060
Increase in expenditure from increasing LET to £11,200 pa							
	Assumption 2	0.0	0.2	0.4	0.8	1.4	2.0
	Assumption 3	0.0	0.2	0.4	0.8	1.4	2.0
Increase in expenditure from increasing LET to £12,300 pa							
	Assumption 2	0.2	0.6	1.6	3.1	5.2	7.7
	Assumption 3	0.2	0.6	1.6	3.1	5.1	7.6
Increase in expenditure from increasing LET to £13,500 pa							
	Assumption 2	0.3	1.1	3.2	6.0	9.8	14.3
	Assumption 3	0.3	1.1	3.2	6.0	9.7	14.2

Table 4 below shows the corresponding effects on the costs of contracted out rebates.

Table 4 - Effect on contracted out rebates of increasing the LET - *£ billion, 1999-00 price terms*

	SP Assumption	2010	2020	2030	2040	2050	2060
Increase in rebate costs from increasing LET to £11,200 pa							
	Assumption 2	0.1	0.1	0.1	0.1	0.1	0.0
	Assumption 3	0.0	0.1	0.1	0.1	0.1	0.1
Increase in rebate costs from increasing LET to £12,300 pa							
	Assumption 2	0.2	0.3	0.2	0.2	0.2	0.2
	Assumption 3	0.2	0.4	0.3	0.2	0.2	0.2
Increase in rebate costs from increasing LET to £13,500 pa							
	Assumption 2	0.5	0.6	0.4	0.4	0.4	0.3
	Assumption 3	0.4	0.7	0.5	0.4	0.4	0.4

Please note that the increases in rebate costs from increasing the LET as shown in Table 4 above are smaller than the increases shown in Table 2. The reason for this is that it has been assumed that an increase in the LET also reduces the level of additional contracting out following the introduction of Stakeholder Pensions. In the baseline costs which appeared in the Report on the Bill, it was assumed that all additional contracting out following the introduction of Stakeholder Pensions is among people with earnings above the LET. Therefore, an increase in the LET reduces the potential pool of people who could contract out through a Stakeholder Pension, reducing the assumed numbers contracting out. This effect reduces expenditure on contracting out rebates, which partially offsets the increased expenditure from increasing the LET.

Finally, please note the difference in approach between the options for increasing the accrual rate on the first band of earnings, and the options for increasing the LET. In the first case, no consequential changes were made to the other parameters of S2P (accrual rates or earnings limits). In the second case, the increase in the LET was accompanied by an increase in the top of the second band of earnings. This approach reflects the current legislation, where the top of the second band of accrual depends on the LET and the LEL but not on the S2P accrual rates. However, this difference in approach should be borne in mind when considering the projected costs of the different options.

ANNEX B

Letter to the Second Clerk from the Government Actuary's Department (PC 24A, 5 March)

I refer to your letter dated 20 February 2002 to Mr Daykin in connection with the Pension Credit inquiry. Mr Daykin has asked me to reply and I apologise for any delay.

You asked for the parameters of S2P that would be needed for the earnings levels shown in our examples for someone retiring in 2051 with a full basic state pension to achieve a total pension income above the level at which:

(i) entitlement to the guarantee credit ceases; and
(ii) entitlement to the savings credit ceases.

I do not think that it is appropriate to envisage different parameters for different levels of earnings; that is we do not want the parameters for a person earning, say, £800 per week to be different from those for someone earning £300 per week. Thus, I believe that the most sensible way to address the issue is to recalculate the S2P parameters in a similar way to that when they were originally set but taking account of the recent changes to the level of the basic state pension and MIG.

The level of the various benefit rates (for a single person) and limits for the year 2002-03, which are relevant to the exercise, are set out in the following table:

	Benefit
Lower earnings limit (LEL)	£ 75 per week
Low earnings threshold (LET)	£208 per week
Upper earnings threshold (UET)	£473 per week
Upper earnings limit (UEL)	£585 per week
Basic state pension (BSP)	£ 75 per week
Minimum income guarantee (MIG)	£ 98 per week
S2P accrual on earnings between the LEL and LET	40 per cent
S2P accrual on earnings between the LET and UET	10 per cent
S2P accrual on earnings between the UET and UEL	20 per cent

With these parameters, based on the same assumptions as in our previous letter, in particular the 1.5 per cent pa real earnings growth assumption, a single person retiring in 2051 who earned the LET every week (or, equivalently, £10,800 per annum) of his working life would be entitled to a total pension from the BSP and S2P of £94 per week in constant 2002-03 earnings terms. Thus, their pension would be approximately £4 per week less than the MIG at retirement assuming that the MIG is increased each year in line with earnings. In fact, because of the S2P underpin, anyone earning between the LEL and LET every year would receive this level of pension.

Our understanding is that at the time the S2P parameters were set, it was expected that, for a person as in the paragraph above, the pension at retirement would have been above the level of the MIG and would have remained above it for a number of years. This is not the case now, principally due to the increases that have been made to the level of the MIG in recent years, offset in part by the increases to the BSP.

The following table sets out the accrual factor to replace the 40 per cent factor that would be necessary for a person who earned the LET every week (or £10,800 per annum) of his working life to achieve a total state pension equal to the MIG at award in the year 2051, if the other parameters were left unaltered. The table also shows the factor that would be required if the total state pension were to exceed the MIG for either five years or 10 years after retirement, assuming that the MIG continued to be uprated in line with earnings and the pension was uprated in line with prices.

	Pension at award equals the MIG	*Pension exceeds the MIG for 5 years after retirement*	*Pension exceeds the MIG for 10 years after retirement*
Change 40 per cent factor to	42.5 per cent	47.7 per cent	53.4 per cent

Alternatively, a similar result could be achieved by increasing the LET and leaving the 40 per cent accrual rate unchanged. The required LET is shown in the table below, again assuming that all other factors are unchanged.

	Pension at award equals the MIG	*Pension exceeds the MIG for 5 years after retirement*	*Pension exceeds the MIG for 10 years after retirement*
Change LET of £10,800 per annum to	£11,200 per annum	£12,300 per annum	£13,500 per annum

It would, of course, be possible to combine a smaller increase in the 40 per cent accrual rate with a smaller increase in the LET and achieve a similar result.

Given the design of S2P, one would expect that if either the 40 per cent accrual rate or the LET were to be altered then there would be changes to the other parameters of S2P but any changes will not significantly affect the figures above. However, the other changes in the limits or accrual rates would affect the amount of S2P payable to higher earners and consequently would affect the benefit levels for the other examples in our previous letter.

Assuming that the MIG is uprated in line with earnings and that the savings credit threshold is uprated in line with prices, then in 2051, there is no entitlement to any part of the pension credit if income is above £390 per week in constant 2002-03 price terms or, equivalently, £190 per week in constant 2002-03 earnings terms. In order for the total state pension at award in 2051 for our example to be £190 per week in constant earnings terms, the 40 per cent accrual rate would need to be replaced by an accrual rate in excess of 100 per cent. It would not be possible to achieve the same result by keeping the 40 per cent accrual rate but increasing the LET since even if the LET were set to be equal to the UEL the resulting pension would still be less than £190 per week. We have not pursued this scenario further in view of these results.

If the MIG and the savings credit threshold are both uprated in line with earnings, then in 2051, there is no entitlement to any part of the pension credit if income is above £132 per week in constant 2002-03 earnings terms. This figure, as one might expect, is similar to the (illustrative) level of £135 per week under which no pension credit is payable in 2003-04 because all the pension credit factors go up in step in line with earnings in this scenario. In order for the total state pension at award in 2051 for our example to be £132 per week in constant earnings terms, the 40 per cent accrual rate would need to be replaced by an accrual rate of 66 per cent. Alternatively, keeping the 40 per cent accrual rate, the LET would need to be £16,100cper annum instead of £10,800 per annum. Of course, one would need to consider the wider consequences for pension credit if the MIG and the savings credit threshold are both uprated in line with earnings.

Again, if changes were made to the 40 per cent accrual rate or the LET then one would need to consider what changes to make to the other S2P parameters.

In considering these results you might wish to bear in mind the following:

1. Many claimants reaching pension age will not have a full entitlement to S2P even allowing for the credits available (note that credits are not given in as many circumstances as they are for BSP). On average, only approximately 65 per cent of the working age population are likely to accrue an entitlement to S2P in any one year, which implies that at retirement awards of S2P will only be based on 32 years on average rather than 49, giving much less than a full entitlement.

2. Whether or not the total state pension will equal the MIG will also be affected by the level of real earnings growth. If one takes the view that an assumption of real earnings growth of 1.5 per cent per annum is slightly conservative then one would need higher accrual rates or LET to target the MIG if real earnings growth is higher. For example, if real earnings growth were to be 2.0 per cent per annum rather than 1.5 per cent per annum then the current S2P parameters will give a total state pension of £89 per week rather than £94 per week in 2051 in constant earnings terms. In this scenario, the 40 per cent accrual rate would need to be replaced by 46.3 per cent (rather than the 42.5 per cent illustrated above) for the total state pension at award to equal the MIG in 2051 for a person who earns between the LEL and the LET for each week of their working life.

3. 2051 is the first year when those retiring will have been in S2P all their working lives but other than that it has no particular significance. In the years before 2051 the position will be different because people will have SERPS for part of their working life rather than S2P. In the years after 2051, the total state pension will continue to reduce relative to the MIG if the MIG continues to go up in line with earnings. For example, under the current S2P parameters, the total state pension at award in 2075 will be £89 per week in constant earnings terms rather than £94 per week in 2051 for the example that we are using.

4. Where state benefits (such as winter fuel allowances and free television licences) are paid to pensioners other than as a basic pension or SERPS/S2P they fall outside the calculations done above. However, it is not clear that it is appropriate to ignore these payments when looking at the overall position of pensioners.

5. We have not produced figures for couples but could do so if required.

I hope that the above comments are helpful. Please let me know if I can be of any further assistance.

David Lewis
Chief Actuary
Social Security

5 March 2002

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